

India's Special Economic Zones: Can they move up a gear?

SUMMARY

1. New laws and regulations on Special Economic Zones (SEZs) are taking effect this year. Emphasis on revitalising SEZs after an unspectacular start, during which the opportunity to experiment by adopting more flexible labour policies and road-test other reform measures in SEZs was not taken. Political backing and administrative support, particularly from State Governments, will be key determinants of success.

DETAIL

2. There has been a policy framework covering Special Economic Zones (SEZs) since 2000. They may be established for the manufacture of goods and the rendering of services. They must be net foreign exchange earners, but are not subject to value addition or minimum export performance requirements. The policy provides for the establishment of SEZ's in the public, (by either Union or State Governments), private or joint sectors. Approvals have been granted to 121 SEZs, of which 61 either have broken ground or are already operational.
3. However, the concept has not taken off in the same way as other major emerging markets, e.g., China. Indian EPZs have had difficulty attracting foreign and domestic investors for a variety of reasons, including:
 - The lack of significant advantages offered by SEZs in terms of labour market flexibility. Attempts in 2005 to roll back restrictions on retrenchment and introduce other flexibilities foundered on coalition politics and the strong opposition from the left wing parties on whose support the governing UPA coalition depends. But there have also been recent signs that Congress has not given up completely on the idea of relaxing labour laws within SEZs;
 - The design and structure of Indian SEZs. They tend to be smaller than their Chinese equivalents, sectorally-focused (e.g., on handicrafts, leather products, auto parts, apparel, electronics and IT services, gems and jewellery, food processing) and separated from their surrounding communities;
 - Conservatism in SEZ policy – Indian SEZs have not been used to test reforms with a view to adopting them subsequently nation-wide (unlike China), and SEZ policy has not been seen as at the cutting edge of reforms here;

- The lack of a natural gateway that could serve as a source of capital and a conduit for the movement of goods in the manner that, e.g., Hong Kong functions for China. India does not have an equivalent, although Dubai and Singapore to some extent fill that role.
4. In order to boost investor confidence and signal government commitment to a stable SEZ policy regime, a comprehensive Special Economic Zone Act was passed in 2005. Enabling legislation meant that the Act came into force in February this year. The main provisions are:
- 100% foreign direct investment ("FDI") permitted under the automatic route to units located in SEZ (which otherwise require certain prior approvals);
 - Tax benefits / holidays for any block of 10 years in 15 years;
 - No capital gains tax on shifting units to SEZ;
 - Exemption from customs duty and excise duty, service tax, central sales tax as well as local levies such as octroi, road tax etc. There is also a proposal for VAT exemption.
5. So could this provide the boost that Indian SEZ's need? A SWOT analysis of SEZ's in India suggests there is significant potential, but many hurdles still to be crossed:

Strengths

- Familiarity with Western concepts of business practices;
- An established legal redress system;
- Relatively low labour costs;
- India's large English speaking workforce;
- A large and growing domestic market.

Weaknesses

- Indian SEZs will have to comply with all Indian labour laws, giving SEZ's no advantages on labour flexibility or addressing labour indiscipline (a ray of hope may be that the Development Commissioner of the zone, who is appointed by the Ministry, will double up as the Labour Commissioner, which could cut the time taken to settle labour disputes);
- Unlike India's Export Processing Zones, which can sell up to 50 per cent of their exports in the Domestic Tariff Area (DTA) at half the rates of customs duties, SEZ manufactures can sell in DTA only on payment of full duties. The ability to sell in the DTA would be an important consideration

for many Export-oriented units/EPZ/SEZ units, as an insurance against downturns in international markets;

- Poor infrastructure;
- High cost of capital;
- Inadequate institutional support: the continuing lack of integration of the various departments involved such as customs, sales tax, environment and pollution control. Without such integration, single window clearance schemes for SEZs cannot operate.

Opportunities

- To use SEZs to catalyse infrastructure development;
- Realistically establish competitive advantages in SEZs;
- A large NRI base who have traditionally invested less in greenfield development in India;
- Lower the high transaction /behind the border costs to exporters;
- Tap the advantages of WTO/increase India's small share of world trade;
- To increase investments in core strength areas like IT and software products and services.

Threats.

- There are signs of an increasing rejection rate for proposals to establish SEZs. This could be linked to the difficulty in reaching agreement between key ministries involved, especially those involved in export promotion or fiscal policy. This could lead to waning business confidence in SEZs.
- Sops provided to the units in the SEZ's could be disputed in the WTO – (eg, different tax treatment for goods specifically for export could give rise to charges of dumping)
- The performance of SEZs will be monitored by a committee headed by the Development Commissioner and consisting of Director General of Foreign Trade (DGFT) officials and customs authorities will monitor the performance of SEZs. But with opposing interests (reducing tariffs to enhance trade for DGFT, maximising tariff revenue for customs authorities), how will these 'natural adversaries' help deliver this mandate?
- Prospect of even more restrictive labour laws being introduced (eg, "reservations" for socially disadvantaged groups in private sector jobs).

Comment

6. SEZs, especially if one or two successful examples emerge, could yet play a significant role as policymakers increasingly follow a more export-led development strategy to accelerate economic growth. But getting political and governance issues aligned behind them will be critical determinants of their success. Unless the State governments are directly made responsible for the

management of SEZs and approving investment proposals, their political leadership and bureaucratic set up may not have any incentive to push the initiative forward. State governments, who have not been associated in the past with export promotion activities, may struggle to do this; at best performance among states will be variable. They will need to have role clarity and a sense of identification with the scheme.

7. But what also might give SEZs a shot in the arm is revisiting, even on a modest or gradual scale, the relaxation of labour norms and regulations. This might be justified to the domestic lobbies on the grounds that they are exposed to uncertain international market conditions. Now that key state elections are out of the way, the climate for taking forward such reforms may be better.

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11 May 2006